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SUBJECT: GERMAN BANKS WEATHERING SUB-PRIME MORTGAGE  
CRISIS FOR NOW; LONGER TERM OUTLOOK STILL UNCERTAIN

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**¶11. (SBU) SUMMARY:** Third quarter reports show that most German banks appear to have weathered the turbulences in the international financial markets. Large private banks such as Deutsche Bank and Commerzbank reported losses in their investment portfolios, balanced by gains in other sectors, resulting in overall third quarter profits. While this has not had much effect yet on the liquidity crisis, the Association of German Banks believes if fourth quarter 2007 reports continue in a positive trend, interbank lending should resume on a more normal basis by the first quarter of 2008. While the full extent of losses is still unclear, analysts cautiously predict that the German banking sector has survived the worst of the crisis. Both government and industry lauded the concerted effort to prevent further contagion to the banking sector in Germany. The Finance Ministry has resisted hastily instituting new procedures in reaction to the crisis. Although fears over further contagion were expected to increase consolidation pressures in the balkanized German financial market at first, the impetus seems to have waned in the face of resistance on the part of the federal states. END SUMMARY.

Liquidity Still a Problem

**¶12. (SBU)** On November 16, Managing Director of the Association of German Banks Bernd Brabaender told Econ Counselor that since no one knows the full extent of German banking losses all banks are trying to be as transparent as possible with their statements. Brabaender added that, while third quarter reports are a positive sign, the industry knows the real test will be in the 2007 yearly statements. If the trend of overall profits continues, this should have a positive impact on the sector's image and ease the liquidity crunch. The real problem now is that trust in the banking sector, even among major financial institutions, is weak. Brabaender pointed to the lack of interbank three-month loans as evidence of this. The lack of liquidity has increased the cost of banking, but interbank lending should resume on a more normal basis if the positive trends continue. Brabaender believes this could happen in February or March, depending on the outcome of overall 2007

results.

#### Sub-Prime Crisis Impact

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¶3. (U) The third quarter reports of all major German banks show positive overall performance despite turbulence on international financial markets. The top three German banks, Deutsche Bank, Commerzbank and Dresdner Bank, all reported either third quarter profits or small losses. This is a striking contrast to Switzerland's UBS or Citibank, which reported sub-prime losses in the tens of billions of dollars for the third quarter.

¶4. (U) Deutsche Bank, the largest German bank, appears to have weathered the sub-prime mortgage crisis reasonably well. CEO Josef Ackermann warned of sub-prime related losses for the third quarter early on. While Deutsche Bank wrote off losses of 2.16 billion euros (\$3.17 billion), overall Deutsche Bank figures show an increase in profits for the period of almost 30 percent, or 1.6 billion euros (\$2.35 billion). Sub-prime related losses were more than compensated by other portfolios, especially in the German retail banking and Asian sectors.

¶5. (U) Commerzbank, Germany's second largest bank, reported 291 million euros (\$425 million) in sub-prime related losses. Commerzbank CEO Klaus-Peter Mueller has been guarded about the long term impact of the crisis on the German banking sector, repeatedly noting the full extent of the losses are as yet undetermined. Despite this, the company surpassed its overall 2007 target of 1.5 billion euros (\$2.205 billion) in the

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first nine months with profits of 1.72 billion (\$2.53 billion) euros. Commerzbank CFO Eric Strutz hopes these profits will be enough to cover any further losses.

#### Rescue Mechanism Worked

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¶6. (SBU) The third quarter results are especially welcome in light of the concern for the entire sector sparked by the near-insolvency of IKB and Saxony LB at the beginning of the sub-prime mortgage crisis. Experts view this as a major achievement by private and public banks, as well as Finance Minister Peer Steinbrueck, to limit the damage early on. The ECB also stepped in on several occasions to inject liquidity in the market in order to stave off a worsening of the crisis. At an October 25 banking conference, the Chairman of the Association of German Savings Banks, Heinrich Haasis, lauded Steinbrueck for his initiative to get both public and private players to the table to develop a rescue plan for IKB. At the same event, banking representatives confirmed that this rescue operation, repeated for Saxony LB a few weeks later, helped the German financial market stay calm. "When we look at what happened in Britain with Northern Rock, we know what we prevented by our action," a banking representative told the Embassy.

¶7. (SBU) All major German financial players have refrained from calling for knee-jerk changes to the international financial system to prevent future crises. Both bankers and officials appear to be waiting to analyze overall 2007 results before adopting any new regulations. Banking officials are concerned that any deepening of the crisis may lead to further regulatory burdens on the industry. Finance Ministry officials told us that it would be well into 2008 before the Ministry would make any concrete suggestions for changes to the existing regime, and then only after an exhaustive review of

the situation. Finance Minister Steinbrueck had publicly called for greater transparency of certain financial products even before the crisis broke. Steinbrueck repeated that call but recently added, in language strikingly similar to the U.S. Treasury, that he prefers a "code of conduct" developed by the industry itself.

¶8. (SBU) Deutsche Bank's Ackermann, in his capacity as Chair of the Institute of International Finance (IIF), said his organization would create such a mechanism by spring 2008. The code of conduct would address improvements in risk management, transparency of banking transactions and seek to avoid liquidity shortages. (Note: The IIF represents 370 private banks worldwide.) Haasis meanwhile admitted that some financial products have become so complex that banks have lost control over their impact on the financial markets.

#### Banking Sector Consolidation: A Long and Winding Road

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¶9. (SBU) The "early victims" of the sub-prime crisis in Germany, notably IKB (reftel A), renewed the debate over a necessary consolidation of the German banking sector. The business model of the larger public state banks (LB), such as Saxony LB, came under attack. Many experts believed the lifting of the state guarantees for these banks in 2005 should have been coupled with consolidation. The Association of German Banks and others have argued that slim profit margins in the domestic market forced state banks to take on too much risk in markets they didn't understand, such as U.S. sub-prime mortgages. Consolidation is considered by most experts to be the inevitable solution.

¶10. (SBU) There are currently 11 such state banks which are intended to serve as the extended arm of local savings banks, providing services for German SMEs investing abroad. The Finance Ministry and the savings banks advocate a merger of the state banks into two major entities. When the troubled Saxony LB was saved by the Baden-Wuertemberg LB (LBBW)--

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effectively LBBW bought Saxony LB -- there were hopes that other state banks would merge. So far though, state politicians have prevented consolidation of this sector. This is especially evident in the case of the Westdeutsche Landesbank (WestLB). On November 14, the state government of North-Rhine Westphalia, the largest single owner of WestLB, stated its intention to block the bank's sale. Given WestLB's 2007 losses of more than 100 million euros (\$147 million), the state government argued it would be the wrong time to sell or merge the bank. A spokesperson for the federal agency for banking oversight (Bafin) told us that banking sector consolidation in Germany would remain "an incremental process, one that has been going on since the 1960s but one should not expect any dramatic progress."

TIMKEN, JR